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No. 84-679

In the Supreme Court
OF THE
United States

OCTOBER TERM 1984

BATEMAN EICHLER, HILL RICHARDS, INCORPORATED
Petitioner,

VS.

CARL F. BERNER, CHARLES BRUNER, DENNIS T. DEMETRE, LAWRENCE EPSTEIN, BARRY S. GLASS, HERBERT GREENBAUM, ROBERT M. JACOBS, ARNOLD R. KEILES, HARRY MITTLEMAN, GARY L. NOBEL, CHARLES P. LAZZARO, LESLIE L. NEADEAU and T.O.N.M OIL & GAS EXPLORATION CORPORATION,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

REPLY BRIEF OF PETITIONER

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PETITION FOR CERTIORARI FILED OCTOBER 24, 1984
CERTIORARI GRANTED JANUARY 7, 1985

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REPLY BRIEF OF PETITIONER

INTRODUCTION AND SUMMARY OF ARGUMENT

Respondents' brief argues that the defense of *in pari delicto* should never be available in private federal securities fraud actions by tippees against tippers. No court ever has endorsed this absolutist view, which ignores entirely the judicial integrity, deterrence and public policy considerations that underlie the more than two hundred year history of the defense. Petitioner's

opening brief ("Pet. Br.") develops fully the factors warranting availability of the defense in such actions and, in so doing, anticipates Respondents' arguments. Petitioner accordingly does not cover that ground again here but instead focuses upon the arguments of the Securities and Exchange Commission ("SEC").

The SEC seeks to support denial of the defense by repeatedly, but erroneously, insisting that its present prosecutorial enforcement position is somehow a congressional policy which warrants overriding the *in pari delicto* defense. No such congressional policy exists. The SEC's surprising depiction of defrauder tippees as relatively benign investors demands response, as well, as do the SEC's conclusory assertions with respect to deterrence.[1]

The bulk of the SEC's position, however, is entirely consistent with Petitioner's. The SEC does not take issue with the fundamental precepts upon which Petitioner bases its conclusion that the defense of *in pari delicto* is available to the broker and broker-dealer under the circumstances that the complaint presents.

The SEC concedes that courts should approve application of the *in pari delicto* defense to some private 10b-5 claims (SEC Br. 6-7), and it recognizes that this Court's decision in *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134 (1968), does not preclude use of the defense in securities fraud actions (SEC Br. 6-7, 12-16). Moreover, the SEC acknowledges that the common law contours of the *in pari delicto* defense guide its application to a tippee-tipper lawsuit. (SEC Br. 9-12, 15-16). The SEC further agrees that principles of judicial integrity and deterrence are the cornerstones for the defense.

[1] Petitioner already has anticipated and taken issue with the SEC's general analysis of deterrence as it applies to cases involving broker-dealers. (Pet. Br. 35-43). However, the SEC's further deterrence analysis in its amicus brief, built as it is entirely upon conjecture, requires additional response. This response appears, *infra*, at 10-12.

(For understandable reasons, however, the SEC buries acknowledgment of the former in a footnote, SEC Br. 26 n.31, and nowhere else explains how the judicial system could avoid suffering damage to its integrity from permitting wrongdoing plaintiffs to recoup their losses.)[2]

Thus, the SEC recognizes that courts should apply the *in pari delicto* defense where plaintiff's fault is substantially equal to defendant's and agrees that the mere fact that a defendant is a securities broker does not itself bar invocation of the defense. Indeed, the SEC advises that:

> The Commission believes that a securities professional should be permitted to invoke the common law *in pari delicto* defense only where the plaintiff's fault is, in fact, substantially equal to or greater than his own—for example, where the plaintiff was involved in an actual conspiracy with the professional to misuse inside information for their mutual benefit. . . .

(SEC Br. 7).

[2] In its footnote 31, the SEC attempts to convince this Court that authorizing suits by tippee-wrongdoers will not undermine public confidence in the judicial process. The SEC does so by arguing based upon its own *ipse dixit* that tippee traders are less blameworthy than tipper brokers and that encouragement of recompense for the tippees' losses furthers the purposes of the securities laws. Petitioner takes issue with each of those contentions. (Reply, *infra*, at 10-12). The SEC then suggests that Congress' express authorization for contribution in Section 9(e) of Securities Exchange Act of 1934, 15 U.S.C. § 78i(e), demonstrates Congress' view that suits by securities manipulators for contribution under that Section would not undermine judicial integrity. To the contrary, the Section reveals Congress' value judgment in the context of Section 9(e) (a similar value judgment appears in Section 18(b) of the Securities Exchange Act, 15 U.S.C. § 78r(b), and Section 11(f) of the Securities Act, 15 U.S.C. § 77k(f) that a right of contribution would effectuate Congress' purposes under those sections of the securities laws because it enlarges the group of wrongdoers penalized for the misconduct causing the loss. The SEC's position does not accomplish these goals. Rather, it would enable one wrongdoer to shift all loss to the other.

Petitioner agrees that the defense should apply in the SEC's chosen example. The case at bar is such a case.

The SEC parts company with the Petitioner, however, when the SEC endeavors to paint a picture of plaintiffs, admitted tippee traders, as parties whom courts applying the securities laws should protect. The effort disregards entirely the harm that such condoning of unlawful conduct would inflict on the judicial system. It sanctions a result which would use the courts to permit recovery of all losses that securities law violators incur because of their attempts to defraud innocent investors.

The SEC's ultimate conclusion rejecting the defense also depends upon a series of predicates for inequality which submerge the knowing misconduct of the respondent plaintiffs and escalate the delict of the broker merely because of his status as such. But the SEC's posited substantially greater fault of the broker is insupportable for the following reasons: (1) the complaint establishes that plaintiffs confirmed with a corporate insider their possession of non-public information on which they should not trade; (2) the provisions of the securities laws relied upon by plaintiffs make no distinction whatever between the conduct of brokers and "any [other] person," and the SEC must look to Congress, not to this Court, for the creation of special duties of brokers under the securities provisions at issue; (3) while the broker who passes on inside information to trading tippees interacts with the guilty, those wrongful tippees defraud the innocent; (4) a broker's fiduciary duty to his client, if any, is no different from the tippee's fiduciary duty under *Dirks v. SEC*, ___ U.S. ___, 103, S. Ct. 3255 (1983), to shareholders who are not privy to his tip; and (5) a tippee's derivative duty under *Dirks* is a duty which he breaches only by his own direct, unlawful acts and thus does not result in liability without culpability.

ARGUMENT

1. The SEC's Culpability Analysis Refuses to Recognize the Allegations of the Complaint Establishing Plaintiffs' Liability for Knowing Securities Fraud

The detailed allegations of the Complaint establish that plaintiffs purchased T.O.N.M. stock because the broker told certain of the plaintiffs that he knew T.O.N.M.'s president and/or vice president personally and had learned material non-public information about the company that, upon publication, would cause a dramatic increase in the value of T.O.N.M. stock. Plaintiffs traded expressly "on the premise" that the information Lazzaro gave them was "information not otherwise available to the general public." (Jt. App. 10).[3] Acting nothing like the innocent dupes that the SEC and plaintiffs paint, the tippees went directly to T.O.N.M. president Leslie Neadeau to verify the accuracy of their tips. Neadeau advised them explicitly that the tips "were not public knowledge and that plaintiffs would have to wait for the publication of TONM's annual report." (Jt. App. 12). Plaintiffs thus learned from the highest corporate insider possible that the information came to them as the result of a breach of duty, that is, via someone who was not supposed

[3] As Petitioner explained in its opening brief (Pet. Br. 15-18) and as the SEC concedes (SEC Br. 17-18), it is immaterial, for purposes of analysis of plaintiffs' violations, whether plaintiffs actually received inside information (as Petitioner contends they did (Pet. Br. 15-16)) or whether plaintiffs instead merely believed that they had received such information. Plaintiffs' failure to recognize this point vitiates their argument (Resp. Br. 10-18) that this Court's requirement of scienter in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), somehow prevents the existence of a violation by the tippees. Because the analysis of the tippees' conduct must proceed from the standpoint of what tippees *believed* to be the operative facts, plaintiffs' factual impossibility argument fails to save them. The tippees' duty to disclose arises not from the truth or falsity of the inside information but from the tippees' belief as to its truth. Similarly, the alleged falsity of the information cannot deprive it of materiality, as the SEC lightly suggests despite its recognition of the applicability of attempt theory (SEC Br. 17).

to disseminate information available at that moment only for corporate purposes and not for personal use or benefit (*Dirks*, 103 S. Ct. at 3261). Plaintiffs also knew that if they acted upon the information, they would have an unfair and unlawful advantage over the other parties to their trades. In addition, plaintiffs obtained from Neadeau "winking" confirmation of the accuracy of the tips, when Neadeau told them that their source was "very trustworthy and a good man" (Jt. App. 12).

In disregard of these facts, the SEC suggests that plaintiffs may not have known that the tips came from an insider with a duty not to disclose the information.[4] Surely no notice short of a flashing neon sign could be more sufficient. Neadeau not only confirmed that the information was "inside" information, but he also made it absolutely clear that plaintiffs were not supposed to trade on that information. This fact renders irrelevant the SEC's "ignorance of the law" suggestion, which would not be a defense in any event. (SEC Br. 20). Thus plaintiffs are not merely technical transgressors who received information to which they believed themselves legitimately entitled. Plaintiffs

[4] The SEC's position apparently would find a violation by a tippee only in a situation where the tipper sat down with the tippee and provided him with secret corporate information, told the tippee it was wrong to give him this information, and then asked him to trade on that information and secretly pass some of his profits to the corporate insider. The Commission has not so constricted its view of unlawful tippee trading in cases post-*Dirks* where it has prosecuted tippees. *See, e.g., United States v. Reed*, No. 84-CR 610, slip op. at 10-11, 17 (S.D.N.Y. Jan. 24, 1985) (available April 5, 1985 on Lexis); *Securities and Exchange Commission v. Thayer*, No. 84-CIV 66 (S.D.N.Y. 1984). *See generally Securities and Exchange Commission v. Musella*, [1983-84 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶99,637 (S.D.N.Y. 1984) (misappropriation); *Securities and Exchange Commission v. Materia*, 745 F.2d 197 (2d Cir. 1984) (misappropriation); *Securities and Exchange Commission v. Lund*, 570 F.Supp. 1397 (C.D. Cal. 1983) (temporary insider).

instead are knowing defrauders, and defendants' alleged fraud cannot excuse theirs.[5]

[5] A plaintiff does not regain the right to recover by charging that his co-conspirator defrauded him. *McMullen v. Hoffman*, 174 U.S. 639 (1898) (no relief among conspirators to defraud in bidding on a public contract); *Collins v. Pioneer Title Insurance Co.*, 629 F.2d 429, 434 (6th Cir. 1980) (plaintiff barred from suing co-conspirator after fraudulently obtaining policy of title insurance); *Ford v. Caspers*, 128 F.2d 884, 885 (7th Cir. 1942) (relief denied against co-conspirator in fraudulent conveyances); 6A *Corbin on Contracts*, § 1536 at 823 (1962) ("Ordinarily one who participates in a conspiracy to defraud third persons is regarded as morally delinquent and not entitled to restitution from another participant."). Rather, relief from application of *in pari delicto* on grounds of fraud is usually reserved for cases where plaintiff is free of fraudulent intent and thus, in fact, is not substantially equal in fault. This exception arises where plaintiff is involved in acts merely *mala prohibita*, *see In re E. J. Arnold & Co.*, 33 F. 789 (E.D. Mo. (1904) (gambling); *Lockman v. Cobb*, 77 Ark. 279, 91 S.W. 546 (1905) (gambling); *Webb v. Fulchire*, 25 N.C. 485 (1843) (gambling); *Hess v. Culver*, 77 Mich. 598, 43 N.W. 994 (1889) (improper dealing with corporation); *Grim v. Cheatwood*, 208 Okla. 570, 257 P.2d 1049 (1953) (gambling), or where plaintiff does not know of the underlying wrongfulness, *National Bank & Loan Co. v. Petrie*, 189 U.S. 423, 424 (1903) (sale of bonds where plaintiff did not know that bank had not authorized transaction).

Where, as here, the plaintiff has deliberately set upon a fraudulent course in concert with defendant, courts will not "draw fine distinction in ascertaining equality of wrong." *See Hess v. Culver*, 77 Mich. 598, 43 N.W. 994 (1889). Relief will be denied unless there is evidence of coercion, oppression, frailty, naivete or other great inequality of condition such that plaintiff did not exercise a "deliberate judgment" to defraud, *see Gorringe v. Reed*, 23 Utah 120, 131, 63 P. 902, 905 (1901) (relief from transaction under duress of threatened criminal prosecution and imprisonment); *Rozell v. Vansyckle*, 11 Wash. 79, 87, 39 P. 270, 273 (1895) (relief available to cancel conveyances by aged man in reliance on defendants' advice); *Barnes v. Brown*, 32 Mich. 146, 148 (1875) (great disparity in business acuity justified rescission of deeds conveyed on defendant's trusted advice); *Harrety v. Kontos*, 238 Mo. App. 519, 184 S.W. 2d 195 (1944) (same); 3 J. Pomeroy, *A Treatise on Equity Jurisprudence* §§ 942-944, 947-948, 948a, 950a, at 738-774 (5th ed. 1941). *See also Jewel Tea Co. v. Local Unions, etc.*, 274 F.2d 217 (7th Cir.), *cert. denied*, 362 U.S. 936 (1960) (*in pari delicto* defense not applied against plaintiff whose antitrust violation was induced by economic necessity); *Peter v. Western Newspaper Union*, 200 F.2d 867 (5th Cir. 1953) (stockholder who, under economic duress, sold his shares in violation of antitrust laws not *in pari delicto*).

Petitioner agrees with the SEC that a comparison of the relative fault of the parties is not based upon "a neat calculus." (SEC Br. at 10 (quoting *Golberg v. Sanglier*, 96 Wash. 2d 874, 883, 639 P.2d 1347, 1353 (1982))). In fact, Petitioner asserts that courts should not use jewelers' balances in order to perform *in pari delicto* substantial equality calculations. Courts instead must decide only (1) whether plaintiff's conduct crosses a threshold of seriousness required to justify barring their claims and (2) whether exceptions for coercion, duress,[6] or congressional elevation of statutory claims over common law defenses apply. Plaintiffs' conduct outlined above is more than sufficiently egregious to bar their claims, and none of the exceptions to the doctrine is applicable. For the SEC to whitewash those violations and to present seemingly insuperable burdens to the establishment of tippee liability is a curious role, indeed, for the agency charged with enforcement of the federal securities laws. The SEC apparently takes this posture because of the result it now seeks from this Court, while at the same time it hopes to preserve for a later day the option to contend that plaintiffs in fact are tippees who violated 10b-5.

2. The SEC's Arguments Seeking to Create a Higher Duty for Brokers Than for Tippees Do Not Find Support in the Securities Provisions in Issue.

Another of the SEC's efforts to avoid substantial equality of fault centers on the argument that the broker is more culpable than his tippees because the broker is a "securities professional." (SEC Br. 2, 7, 16, 21, 23). The SEC thus would have this Court create a new class of parties heretofore unknown to Section 10(b), Rule 10b-5, and Section 17(a). The argument apparently is that because Congress expressly regulated the activities of brokers and dealers in certain sections of the securities laws, it endorsed greater liability for brokers and dealers in the other sections of the securities laws where it

[6] *See* cases cited in footnote 5.

did not see fit to create standards for brokers and dealers different from those for "any [other] person." This Court has previously dispatched similar arguments by the SEC.[7]

The SEC also argues that a broker's culpability should be greater than a tippee's merely because a broker owes his customer a fiduciary duty. Any fiduciary duty that a broker owes his customers, however, is entirely beside the point in an analysis of substantial equality of culpability of a defrauding broker and defrauding tippee.[8] This analysis focuses upon conduct, not status. The existence of a fiduciary duty from a broker to his client has only a limited legal effect. The most significant aspect of this effect is the creation of an obligation to disclose facts that, absent the duty, he would be free to omit.[9] Thus, the duty may create a legal obligation where none otherwise would have existed, but it neither increases the

[7] In *Ernst & Ernst v. Hochfelder, supra*, 425 U.S. at 200-01, this Court rejected the SEC's arguments in favor of a negligence standard and, after citing three different standards of liability that Congress established in three different parts of the securities laws, noted:

> It is thus evident that Congress fashioned standards of fault in the express civil remedies in the 1933 and 1934 Acts on a particularized basis. Ascertainment of congressional intent with respect to the particular section of the Acts must therefore rest primarily on the language of that section. Where, as here, we deal with a judicially implied liability, the statutory language certainly is no less important.

425 U.S. at 200-01. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 734 (1975) ("When Congress wished to provide a remedy to those who neither purchase nor sell securities, it had little trouble in doing so expressly."). This Court has often observed that questions regarding Congress' intent require resort in the first instance to the language of the statute. *See, e.g., Ernst & Ernst v. Hochfelder, supra*, 425 U.S. at 197 ("In addressing this question, we turn first to the language of § 10(b), for '[t]he starting point in every case involving construction of a statute is the language itself.'") (quoting *Blue Chip Stamps v. Manor Drug Stores, supra*, 421 U.S. at 756).

[8] Even were there any merit to the SEC's argument, it would apply only to those plaintiffs who were customers of Lazzaro and not to the remaining plaintiffs. A careful reading of the Complaint reveals that not all plaintiffs were his customers.

[9] See Restatement (Second) of Torts § 551 (1977).

severity of an otherwise existing violation by a broker nor diminishes the severity of a customer's own violation. In any event, Plaintiffs' allegations against the broker here under the federal securities laws are not dependent upon the existence of fiduciary duty.

Even if fiduciary duty were relevant to the calculus that the SEC invites, the argument still could not save plaintiffs. They, too, breached a fiduciary duty — to the innocent parties on the other side of their trades. They "acquire[d this] fiduciary duty to disclose or abstain" when they learned inside information that they knew emanated from Neadeau's breach of his fiduciary duty to the corporation's shareholders. *Dirks v. SEC, supra,* 103 S. Ct. at 3265-66 n. 23. Nor is this duty lessened by the derivation of the tippees' breach of duty from that of Neadeau. The SEC's argument that derivative liability is less serious might have some merit when applied to vicarious liability (as, for example, when an employer who has committed no affirmative misconduct is held liable as a matter of law for misconduct of an employee). It has no applicability to a tippee who derives his duty from an insider but breaches that duty only by his own willful conduct.

3. Acceptance of the SEC's Position Would, as Noted by the Courts of Appeals of the Third and Fifth Circuits, Encourage Tippee Insider Trading.

The SEC's deterrence arguments deserve no special weight because they are based merely upon the SEC's speculations regarding the effect of the *in pari delicto* defense—speculations created to endorse the conclusions that the SEC advocates here.[10] In our view, the deterrence analysis by the Courts of

[10] This Court frequently has declined to give special weight to the SEC's views in situations where, as here, the SEC advocates a position on the ground that it serves the SEC's prosecutorial goals, but that position does not find support in the language of the securities laws. *See, e.g., International Brotherhood of Teamsters v. Daniel,* 439 U.S. 551, 566 (1979) ("[T]his

(Footnote continued on following page)

Appeals of the Third and Fifth Circuits in *Tarasi v. Pittsburgh National Bank,* 555 F.2d 1152 (3d Cir.), *cert. denied,* 434 U.S. 965 (1977); and *Kuehnert v. Texstar Corp.,* 412 F.2d 700 (5th Cir. 1969), is more persuasive. As those courts note, the focus upon tippers pays insufficient heed to the encouragement of tippee misconduct that the elimination of the defense would create. Barring the defense on the grounds that the SEC asserts would leave the tippee, who has learned inside information unlawfully, with virtually no downside risk. If the information is true, the tippee stands to profit, perhaps enormously, with only the slimmest chance of discovery and proof of the violation either by the SEC or by the other parties to his trades. If the information is intentionally false, he may sue his broker and recoup his losses.[11] Fear of prosecution by the SEC is not a

(Footnote continued from previous page)

deference is constrained by our obligation to honor the clear meaning of a statute, as revealed by its language, purpose and history. On a number of occasions in recent years this Court has found it necessary to reject the SEC's interpretation of various provisions of the Securities Act."); *Piper v. Chris-Craft Industries, Inc.,* 430 U.S. 1, 41 n. 27 1977) ("[The SEC's] presumed 'expertise' in the securities-law field is of limited value when the narrow legal issue is one peculiarly reserved for judicial resolution, namely whether a cause of action should be implied by judicial interpretation in favor of a particular class of litigants. Indeed, in our prior cases relating to implied causes of action, the Court has understandably not invoked the 'administrative deference' rule, even when the SEC supported the result reached in the particular case.")

[11] The SEC agrees with the conclusion of the Ninth Circuit Court of Appeals that the tippee's "warranty of accuracy" is imperfect because the tippee may not be able to recover his losses if the broker passes on information that the broker reasonably believes to be true but that later does not lead to the expected results. That the warranty may be thus limited, however, does not undermine is effect. The result that the SEC advocates still leaves the tippee with substantial encouragement to trade on inside information wrongfully obtained. The tippee deciding whether to act on that information would know that in two out of the three possible scenarios, he does not have to worry about losing his money. Even under the third scenario (of no broker scienter), he still may be able to bring suit under common law theories that employ a standard less rigorous than scienter.

realistic deterrent in "false tip" cases, because the SEC has not expressed any intent to prosecute recipients of false tips. Indeed, the SEC strains to purify plaintiffs' conduct here.

Contrast this situation with that the tipper faces. The SEC has at its disposal the very real remedies Petitioner cites (Pet. Br. 38 n. 31), and those remedies threaten the very livelihood of the brokers.[12] Moreover, the SEC and the self-regulatory agencies possess powers which permit relief against brokers without costly and time consuming resort to court process.[13] Hence, wrongdoing brokers know that swift justice awaits them.[14]

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[12] The elimination of wrongdoing tippees from the class of possible plaintiffs does not mean that no one is available to sue the tipper in a private action, either. The other parties to the tippees' trades who lose money as a result of the tippees' unfair informational advantage or as a result of the market effects of the tippees' trading may sue the tipper without bar, because those plaintiffs are not guilty of any misconduct.

[13] *See* 5C A. Jacobs, Litigation Practice Under Rule 10b-5 § 261.05 (2d ed. 1985) and authorities cited therein.

[14] If the SEC feels that its numerous enforcement remedies are insufficient and that brokers also should be deprived of common law defenses, the SEC should address its arguments to Congress, not to this Court. *Radzanower v. Touche Ross & Co.*, 426 U.S. 148, 156 n.12 (1976); *Mercantile National Bank v. Langdeau*, 371 U.S. 555, 563 (1963). To date, Congress has not expressed its desire to eliminate these defenses but instead has acquiesced in judicial recognition of common law defenses to federal securities law claims for more than forty years. *See, e.g.*, cases in Pet. Br. at 22-28, and the following additional cases dating as early as 1941: *Goldenberg v. Bache & Co.*, 270 F.2d 675, 681 (5th Cir. 1959) (plaintiff's claim barred by laches for failure to complain of facts of which plaintiff was aware); *Tobacco and Allied Stocks, Inc. v. Transamerica Corp.*, 143 F. Supp. 323, 327-28 (D. Del. 1956) (defendant allowed to assert laches if circumstances warrant), *aff'd*, 244 F.2d 902 (3d Cir. 1957); *Carr v. Warner*, 137 F. Supp. 611, 614-15 (D. Mass. 1955) (plaintiff's claim barred by waiver for failure to complain of facts of which plaintiff was aware); *Nash v. J. Arthur Warner & Co.*, 137 F. Supp. 615, 618 (D. Mass. 1955) (companion case to *Carr*); *Rosenberg v. Hano*, 121 F.2d 818, 821-22 (3d Cir. 1941) (plaintiff barred from recovery because of his lack of diligence in discovering fraud perpetrated against him); *see also Consolidated Engineering Corp. v. Nesbit*, 102 F. Supp. 112, 114 (S.D. Cal. 1951) (corporation estopped from recovering short swing profits).

CONCLUSION

For the reasons stated here as well as in Petitioner's opening brief, this Court should reverse the judgment of the United States Court of Appeals for the Ninth Circuit and enter a judgment dismissing this action and holding that plaintiffs' implied securities fraud claims are barred by the *in pari delicto* defense, because of plaintiffs' admitted violations of the very statutes they seek to assert against Petitioner.

Respectfully submitted,

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